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TAGS: ECON ETRD EINV CI
SUBJECT: CHILE'S ECONOMY IN 2005: GOOD GROWTH, LOW
INFLATION AND DECLINING UNEMPLOYMENT

¶1. Summary: 2005 was another good year for the Chilean economy. Chile enjoyed real GDP growth of 6.3 percent, slightly better than in 2004. GDP per capita topped USD 7000 for the first time. Record prices for copper together with a sharp increase in domestic demand were the main growth factors. Inflation remained within the 2-4 percent target and unemployment hit an eight-year low at the end of 2005. The overall trade surplus was USD 9.2 billion, but export growth moderated compared to recent years. Import growth remained strong. There are issues to watch: foreign direct investment showed a sharp drop; the Chilean peso strengthened enough to cause concern about export competitiveness; the country continued its dependence on energy imports; and exports lacked diversification. Most forecasts predict GDP growth in Chile in 2006 to be again in the 5.5-6.25 percent range. Chile is not expected to alter any of its major economic policies under President Michelle Bachelet, who took office on March 11, 2006. End summary.

Good GDP Growth Thanks to Copper and Domestic Demand

¶2. In 2005, Chile enjoyed real GDP growth of 6.3 percent. Growth was strongest in the first and second quarters, at 6.6 percent and 7.2 percent respectively. The drop-off to 5.8 percent growth in the third and fourth quarters was caused mainly by a decline in copper production due to an earthquake in northern Chile. The overall GDP effect of the drop-off in copper production highlighted Chile's heavy dependence on copper as the engine of economic growth. In 2005, copper represented 43 percent of Chilean exports. Another key factor in Chile's good GDP growth rate was a surge in domestic demand by 11.4 percent. There was a significant expansion of both private (8.2 percent) and public (4.5 percent) consumption, leading to an overall increase in consumption of 7.6 percent.

Investment - A Clear Drop

¶3. According to Chile's Foreign Investment Committee, foreign direct investment in 2005 was USD 3.7 billion, a nearly 50 percent drop compared to USD 7.1 billion in FDI in 2004. The mining, transportation and telecommunications sectors were the main investment recipients. Among the sources of FDI in 2005, Australia ranked first (27 percent of FDI), Mexico second (26 percent) and the UK (13 percent). FDI from the U.S. totaled just under USD 80 million, a ten-year low. Despite the lack of U.S. investment in 2005, the U.S. remains the most important source of FDI in the 1974-2005 period,

accounting for 26.5 percent of total FDI in Chile. There has been curiously little government or public reaction to the lower FDI numbers. From those few who have commented on ways to attract more FDI, there have been calls to increase spending on research and development, to improve Chile's education system, to add flexibility to notoriously rigid labor laws, and to improve protection for intellectual property rights.

International Trade - New Heights

¶4. Chile's international trade in 2005 totaled $69.8 billion. This marked a 28 percent increase over 2004, with international trade USD 15.1 billion higher than 2004. Exports in 2005 totaled USD 39.5 billion and imports reached USD 30.3 billion, the highest levels in Chilean history. The trade surplus grew slightly in 2005, to USD 9.2 billion as compared to USD 9 billion in 2004. Over the last three years, exports have grown by an average rate of 30 percent and imports by 24 percent. This growth in trade occurred mainly with countries with which Chile has signed trade agreements over the last three years. Chile boasts no fewer than fifteen trade agreements. Some are full-fledged free trade agreements (such as with the U.S.) and deal with trade, services and investment. Others are much more limited (the agreements with India and China) and cover primarily trade in goods sectors.

¶5. Chile witnessed growth in trade with all of its partners, whether it had a trade agreement or not. Chile's top trade partners in 2005 were the United States, China, Japan, and Korea. China moved up from the third to second spot, and

2005 marked the first time three of Chile's top four trading partners were Asian countries. There were significant increases in trade with Europe (24 percent), North America (29 percent) and Asia (29 percent). Trade with regional trade blocs also saw increases of 25 percent with MERCOSUR and 34 percent with NAFTA. Chile signed trade agreements with China and India in 2005, though neither had been ratified as of March 2006, and in early 2006 it began formal negotiations with Japan. According to the head of the GOC's negotiating team, Chile hopes to complete an agreement with Japan in 2006.

¶6. Over the course of 2005, the Chilean peso appreciated considerably, especially against the U.S. dollar. The peso-dollar exchange rate ended 2005 at 512 pesos to a dollar, from an initial ratio of 557 pesos/dollar and a mid-year peak of 592 pesos/dollar. For comparison, the 2004 peso to dollar average was 610. A six-year low of 510 pesos to the dollar was reached in December 2005. Record high prices for copper were generally seen as the main driver behind the strengthening peso. The elevated value of the peso has led to growing concerns among Chilean exporters. However, to date there has not been a measurable decline in export growth attributable to the stronger peso -- with the possible exception of fruit.

Composition of Exports

¶7. Despite the expansion of trade ties, Chile's exports have yet to achieve a great degree of diversification. Sixteen products represented 72 percent of total exports. The most important exports in 2005 were copper, molybdenum, salmon, wood pulp, wood, wine, fresh grapes and methanol. The overall rise in exports was driven by mining sales, which reached USD 21.2 billion. This was up from USD 16 billion in 2004 and just USD 7.9 billion in 2003. Copper accounted for the bulk of the increase in mining sales, with exports of copper alone hitting over USD 17.4 billion. In dollar terms, copper exports in 2005 represented 43.8 percent of the total value of Chilean exports. Copper prices in 2005 were 27 percent higher than in 2004. Sales of molybdenum, Chile's second largest source of export earnings, totaled USD 3.4 billion in 2005, up from USD 1.5 billion in 2004.

¶8. By contrast, the forestry industry faced relatively weak demand and prices in 2005. The total export of wood products increased only three percent and prices declined by two percent. Total fish exports, mainly salmon, reached new highs in 2005 totaling over USD 3 billion. In 2005, the salmon industry increased its total volume by 13 percent and its price by 9 percent. Wine increased its volume 4 percent and prices 3 percent. Over the first three months of the 2005-2006 fruit export season (which opened September 1 with its reverse season), sales showed a drop of 10 percent. This was caused in part by crop damage from unusually wet weather during the Chilean spring, but many observers suspect the stronger peso has also hurt fruit exports.

Imports -- Dominated by Oil and Capital Goods

¶9. The purchase of intermediate goods, particularly oil, rose to over USD 17 billion in the first 11 months of 2005. This was up from USD 13 billion in the same period in 2004. Almost half of the increase in the value of intermediate goods was due to the higher price of oil. Chile is almost entirely dependent on imports to meet its hydrocarbon energy needs, and oil accounted for 13 percent of Chile's total imports in 2005. The import of capital goods was up sharply, increasing by 56.5 percent to USD 6.5 billion in the first 11 months. Over the same period, imports of consumer goods increased by 19.6 percent to USD 4.3 billion. The greatest increases in imports in 2005 came from Europe with imports growing by 39 percent (representing 18 percent of Chile's total imports). They were followed by Asian imports, which grew 35 percent (19 percent of total imports), and the U.S. with a 30 percent increase in imports (representing 56 percent of total imports). Overall, total imports grew by 33 percent in 2005. The main countries of origin for imports were the United States (6 percent), Brazil (4.5 percent), Angola (3.4 percent), China (3.1 percent), Argentina (3.0 percent), Peru (1.8 percent), Korea (1.7 percent), Germany

(1.6 percent) and Finland (1.4 percent).

U.S.-Chile Free Trade Agreement

¶10. The second year of the U.S.-Chile FTA saw further strong growth in bilateral trade. Trade between the United States and Chile grew 38 percent during 2005, compared to the 31 percent increase in 2004. Overall, since the start of the FTA on January 1, 2004, bilateral trade is up 85 percent. Total trade for 2005 reached about USD 11 billion, representing 16 percent of Chile's total trade. In 2005, Chilean exports to the United States grew 40 percent, reaching about USD 6 billion. Imports from the U.S. in 2005 increased by 44 percent to USD 5 billion. Despite the phenomenal growth in bilateral trade, there has not been an accompanying increase in U.S. investment in Chile. While the U.S. remains the number one destination for Chilean investment abroad, U.S. investment in Chile in 2005 hit a ten-year low. The drop in U.S. investment mirrored the decline in overall FDI in Chile.

Improved Employment Picture

¶11. In 2005, Chile experienced a further steady decline in the average unemployment rate. The yearlong average unemployment rate dipped to 8 percent from 8.8 percent in
¶2004. The labor force increased by 0.6 percent to just over 6.3 million, while the number actually employed reached about 5.8 million, up 1.7 percent from 2004. There was a net gain of just under 100,000 new jobs from the creation of 153,000 new salaried positions. The most active sectors in creating jobs were financial services, with almost 48,000 new jobs, and retail accounting with 23,000. At the same time, 39,000 jobs were lost in the manufacturing sector, mainly in the textile industry. For the November 2005)January 2006 quarter -- when employment traditionally rises due to

seasonal factors affecting the agricultural, tourism and construction sectors -- unemployment dropped to 7 percent. This represented the lowest unemployment rate in eight years.

Monetary Policy Tightening

¶12. With real GDP growth strong and steady, the Central Bank began tightening monetary policy in September 2004, when interest rates stood at 1.75 percent. Since then, the Central Bank has raised its benchmark interest rate to 4.75 percent. In a recent public statement, the Central Bank called monetary conditions "still significantly expansive," strongly implying the rate increases would continue in 2006. Annual inflation for 2005 was 3.7 percent, which still was within the Central Bank,s target range of two to four percent, although clearly at the high end of that scale. By the end of February 2006, the twelve-month moving inflation rate had hit 4.1 percent. All indications are that the Central Bank's inter-bank lending rate will rise to 5.5 percent by the end of 2006. As further incentive for the Central Bank to continue its tightening, the money supply finished 2005 with further expansion. M1A grew significantly in December 2005, reversing a trend of lower growth during most of 2005. It ended the year recording a real growth rate of 7.3 percent. M2A finished 2005 with a real annual expansion of 18.9 percent.

¶13. Commercial bank lending also showed evidence of significant growth. According to the Superintendency of Banking and Financial Institutions, total net loans in Chile's banking sector, which includes 26 financial institutions, rose 13.8 percent in 2005. Net profit rose 12.7 percent, or USD 1.51 billion, in 2005. Consumer lending rose 20.33 percent and home mortgages grew 16.24 percent. Business lending rose 12.51 percent. It is doubtful these high rates of expansion will continue as the impact of higher and rising interest rates are felt in 2006.

Business Confidence Steady

¶14. Chile's most widely-read monthly business confidence index, the Adolfo Ibanez University report, stood in February 2006 at 62.37. Any score over 50 is considered indicative of

business optimism about economic activity for the next three to six months. Over the last twelve months, beginning in February 2005 at 64.43, the average for 2005 was 61.19, slightly higher than the 2004 average.

Financial Markets

¶15. Chile's main stock market, Santiago's Selective Share Price Index (IPSA) showed a gain of 9.4 percent in 2005. This followed gains of 21 percent in 2004 and 48.5 percent in
¶2003. After a strong start in the first two quarters of 2005, the market consistently lost ground in the last two quarters. The Central Bank's tighter monetary policy is generally viewed as the main factor in the declining rate of returns in 2005. The stronger peso is also seen as a factor in limiting share returns. Despite these factors, and the limited return compared to the two previous years, the value of share trading in 2005 reached an all-time high of USD 20 billion.

Comment: Challenges Remain

¶16. While Chile's all-around economic performance remains the envy of many developing countries, there are important caveats. The economy remains dependent on energy imports. While there is no short-term expectation that it will not be able to afford this dependency, it must think strategically to develop a long-term energy plan. Unemployment touched an eight-year low when it hit seven percent in February 2006, but reducing unemployment further, along with addressing

income inequality and shoring up Chile's privatized pension plan, will remain major challenges for the Bachelet administration. While employment figures are up, so are anxieties about the economy's ability to sustain this level of employment. An early 2006 poll showed that fully half of all Chileans were worried about losing their job in the next year. Strong real GDP growth, booming exports and sound fiscal and monetary policies have not translated into psychological economic security for the majority of Chileans. Much of the positive economic numbers in Chile stem from growing world demand and record prices for copper. If/when this demand slackens, there could be serious consequences throughout Chile's economy as government budgets and domestic spending shrink.
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